EXHIBIT 1
DATE 01/23/2013
HB 78

Testimony
House Bill No. 78
Introduced by Rep. Keith Regier

By Request of the Teachers' Retirement System

Testimony in Support of HB 78
By David L. Senn, 444-3376
January 23, 2013

Under current law, a retired member of the Teachers' Retirement System (TRS) may return to work in a TRS reportable position and is allowed to earn up to one third of their final average compensation without loss of benefits. Under HB 78 TRS members who terminate and retire after January 1, 2014, will be required to have a 180-day break in service before they would be eligible to return to work in a position reportable to TRS, other than as a substitute teacher who could teach up to 30 days during the 180 day period. The requirement for a 180 day break in service helps ensure compliance with pension plan qualification standards under the Internal Revenue Code and with proper tax coding of payment of retirees' benefits. This proposal will not affect any TRS member who is already retired or members who terminate and retire on or before January 1, 2014.

FY 2012 Working Retirees Percent of Allowable Earnings	
Number of Retirees	Percent 1/3 Earning Limit
263	1 – 5%
150	6 – 10%
187	11 – 20%
267	21 – 50%
98	51 – 75%
55	76 – 90%
100	91 – 100%
Total 1124	

Background
HB 78 was developed following an exhaustive review by TRS Tax Counsel, Ice Miller, of the IRS requirements regarding retired members returning to work in TRS reportable positions. We asked Ice Miller to review the IRS qualification and tax coding standards as applicable to retirees returning to work in TRS reportable positions and to make recommendations for reasonable plan requirements to ensure compliance with the IRS standards. Ice Miller provided an 18 page memo discussing IRS requirements for termination of employment, bona fide separation from service, and tax coding, and recommendations for ensuring compliance, including through application of a significant break in service requirement.

Qualification Issue

The IRS requires a qualified plan to ensure that retirement benefits are paid to members only after they have actually retired, which means that the member must have terminated employment and must have had a bona fide separation from service. Failure to do so may jeopardize the tax-qualified status of the retirement plan.

Why is qualification under Code Section 401(a) so important to TRS members, retirees, and beneficiaries? The primary advantages in TRS maintaining "tax-qualified" status are that:
• employer contributions are not taxable to members as the contributions are made (or even when vested); taxation only occurs when plan distributions are made;
• earnings and income are not taxed to the trust or the members (until distribution);
• mandatory employee contributions can be made on a pre-tax basis;
• certain favorable tax treatments may be available to members when they receive plan distributions, e.g., ability to rollover eligible distributions.

These advantages would generally not apply to a non-qualified plan.

Ice Miller's memo quotes from a recent IRS Private Letter Ruling (PLR) in which the IRS addressed how a retiree's return to work may affect the qualified status of a plan. In the PLR, the IRS stated that a retirement plan that allows an employee to retire, with the explicit understanding between the employee and the employer that the employee will return to work for that employer, would violate section 401(a) of the Code and result in disqualification of the plan.

Ice Miller's memo also discusses advice given by the IRS to Senator Sarbanes regarding an inquiry requested by a constituent of the Senator. The IRS' response discussed what constitutes a "bona fide separation from service." After stating that "bona fide separation from service" is not defined in IRS code or rule, but that relevant case law and IRS guidance describe a bona fide separation from service, the IRS indicated that a determination regarding whether there was a bona fide separation from service would be based on the specific facts and circumstances of each case.

Other Applicable TRS Law
TRS has long-standing statutory requirements for termination of employment and attainment of retired member status prior to eligibility to return to work as a working retiree of the retirement system, and imposes limitations on the earnings of working retirees. The final piece in this return to work policy to help ensure TRS is in compliance with the IRS regulations is a statutory break in service.

Tax Counsel's Recommendation for Designing a Return to Work Policy

1. Ensure Termination of Employment
TRS must ensure that a retiring member has terminated employment in all TRS-reportable positions. Termination of employment means that the employment relationship has been fully severed. The IRS takes the position that the employment relationship is not fully severed even if there is a substantial modification of the hours worked. The final Treasury Regulations state that "retirement does not include a mere reduction in hours that an employee works. It is also important to realize that the IRS

may not consider the employment relationship to have been severed if the member becomes the leased employee or independent contractor of the same employer. These requirements are provide for in current law, 19-20-731, MCA.

2. Ensure There is No Pre-Arranged Agreement to Return to Work

TRS policies and procedures currently require both the retiring member and their employer to certify whether or not there is any agreement to return to work. When an agreement exists, the applicable IRS guidance is followed.

3. Reasonableness of a Break in Service Requirement

The IRS has stated repeatedly that the determination of whether there is or is not a severance from employment is to be made using a facts and circumstances test. Because applying a facts and circumstances test to each TRS member who retires would be administratively infeasible, TRS inquired of Ice Miller whether a uniformly applied break in service requirement to help ensure compliance with the IRS standards might provide a "safe harbor" for the retirement system. Ice Miller found that, based on guidance regarding the IRC Section 457 and Section 410 regulations, the IRS has indicated that a 12-month break in service period could be viewed as reasonable assurance of termination/bona fide separation from service and may serve as a safe harbor (though no express determination of a safe harbor or the parameters of a safe harbor have been issued).

Summary

Ice Miller advised that a substantial break in service requirement would assist TRS in ensuring that the IRS termination/bona fide separation from service requirements are met, and that a 180 day break in service is reasonable based on TRS' status as a teachers' retirement plan, as a break-in-service requirement would reasonably need to be long enough to provide for a period of separation from service beyond the summer break generally taken by public school districts.

To address school districts' likely concerns for finding qualified teachers to fill in in the absence of a teacher, Ice Miller advised that an expanded break-in-service requirement could provide a reasonable exception for limited service as a substitute teacher after attaining "retired member status" but before expiration of the 180-day waiting period. However, reemployment as a substitute teacher **without a separation from service** would result in the imposition of the 10% penalty under the Code if the retiree is less than age 59½.

We ask for your support of HB 78, and will be available to answer any questions.